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4Q 2009 MARKET OUTLOOK

Risk Retrenchment and a USD Recovery

Highlights

- **Ranges may define FX rates into 2010**

With interest rates likely on hold for most of the major central banks well into 2010, and economic growth likely to remain soft and uneven in the G10, we don't foresee a significant directional trend developing. Exceptions to this outlook are for the AUD and NOK, which are likely to see rate hikes in 4Q and likely outperform other G10 currencies. As a result, a range-trading environment seems most likely to us, with important implications for trading strategies.

- **USD to remain generally weak, but some recovery likely**

With US interest rates near zero and unlikely to be raised before late-2010, we expect the USD will remain under pressure. However, USD weakness threatens to undermine the global recovery by driving up commodity prices and undercutting personal consumption. We also expect to see a correction in most risk assets (stocks and commodities), which has the potential to see the USD strengthen on short-covering and safe haven demand.

- **Risk of extreme USD weakness, but likely short-lived**

There is a risk that the USD could come under extreme pressure in light of near-universal USD bearish sentiment and seemingly blithe US Treasury protests in favor of a strong dollar. However, a sharply weaker USD is likely to disrupt global financial market stability, threatening the economic rebound, which raises the potential for concerted G20 intervention to support the USD.

- **Inter-market correlations are likely to persist**

In the absence of the traditional drivers of currency values (changes to interest rates and growth outlooks), we expect markets to continue to trade with a high degree of inter-market correlation.

- **Expected ranges for key pairs in 4Q**

EUR/USD: 1.38-1.48; risk to 1.33 if below 1.3750

GBP/USD: 1.52-1.65; risk to 1.46 if below 1.52/53

USD/JPY: 88/98; risk to 103 if above 98.50

USD/CHF: 1.02-1.13; risk to 1.18 if above 1.1300

AUD/USD: 0.77-0.90; risk to 0.95 if above 0.9000

NZD/USD: 0.63-0.73; risk to 0.76 if above 0.7300

USD/CAD: 1.05-1.15; risk to 1.20 if above 1.1500

EUR/GBP: 0.85-0.93; risk to 0.97 if above 0.9300

EUR/JPY: 125/135; risk to 120 if below 125.00

XAU/USD: 870/1075; risk to 700 if below 860

Brent crude oil: 55/73; risk to 40 if below 55

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Risk Retrenchment and a USD Recovery

As the title of our outlook suggests, we're looking for an overall USD recovery in the fourth quarter on the back of a relapse in global risk sentiment. But because of a number of factors at work, we don't expect any meaningful trend to take hold and for an overall range-bound trading environment to develop. Moreover, we think such a range environment will provide for a target-rich, short-term trading environment. While we do expect the USD to recover, we are not forecasting a significant USD rebound. If we are going to be wrong in this call, it's most likely by underestimating the extent of the market's optimism over the global recovery outlook and with that the upside in risk assets and the downside in the USD. But we think time is on our side and that as the softness of the global recovery becomes more apparent in coming months, risk appetites will falter. Lastly, in the absence of traditional currency drivers, like changing interest rate or inflation expectations, we think recent inter-market correlations will to continue to be the main catalysts to currency movements.

Anticipating ranges…

We think ranges are the most likely outcome for the fourth quarter because many of the typical drivers of currency rates are simply not in play. The two main traditional drivers of FX are interest rates and economic growth outlooks. Interest rates are going to remain on hold in the G7 currencies, certainly through the 4th quarter, and very likely into the middle of next year. The second potential trend driver is economic growth outlooks. Growth outlooks in the G7 are extremely meager for the developed nations, well into 2011, so we don't think it's much of a stretch to discount 4Q growth views as a trend catalyst. With unemployment high and still rising, personal consumption is likely to be restrained and that will ultimately rein in overall growth expectations. We expect incoming data to reflect this, and we expect to see a fair amount of back and forth in various data series. We also expect to see a fair amount of variation and differentiation in relative growth outlooks, with Europe in particular at greater risk of slipping back relative to the US, Canada and the UK, but that may be more of a story for the first or second quarter of next year. Between circumscribed growth potential and uneven economic data, we also don't see the makings of any significant trends.

USD to stay weak, but some recovery is likely…

In the fourth quarter, the USD is likely to remain generally weak, but we also expect some modest recovery and that the worst case fears of a pronounced USD slide will not materialize. We'd also note overly optimistic risk appetites; near universal dollar bearishness and excessive risk asset bullishness. We think most of those factors will fade in time, leaving US interest rates as the lone real USD negative and why we think the USD will remain mostly on the weak side. On US rates, the Fed is going to continue its near zero US interest rate policy well into 2010 and we expect Fed rhetoric to remain exceptionally cautious on the outlook, which should keep a lid on US Treasury yields. On the other side, still to come massive US deficit borrowing is going to maintain a huge amount of supply in the Treasury market, effectively keeping a floor under US Treasury yields. Together, US rates seem likely to remain in a range at low levels and this adds to our view that the USD should remain broadly range-bound. On the positive side, the USD still functions as a safe haven in times of market turmoil, but it has increasingly been used as a funding currency of choice for speculative traders. The dollar's use as a funding currency will maintain the inverse correlation between stocks and commodities and if we do see a risk correction, the USD should benefit as a result. Lastly, the USD has fallen to politically sensitive levels, which is evident in the recently escalated level of official rhetoric opposed to further USD weakness and home currency strength. We expect G7 officials to continue protesting USD weakness, and for the US Treasury to step up its efforts in support of the USD.

Small risk of greater USD weakness…

In light of current levels and bearish sentiment, the risks are clearly to the downside for the USD against most other major currencies. Part of this has been due to confusing official comments, especially from the new Japanese finance minister. However, a sharp USD decline would be unsettling for a still fragile global financial system, and, especially in the case of the JPY, but also for Europe, devastating for struggling exporters. More importantly, a sharp USD decline has the potential to send commodities soaring, leading to higher food and energy prices, undercutting personal consumption, which is the key to any sustained global recovery. At a time when policymakers around the world are doing their utmost to support consumption, a sharply weaker USD poses a significant threat. As a result, we think there is consensus for the G7 to act should the USD weaken precipitously and we would anticipate concerted intervention, possibly expanding to the G20, should that occur.

Correlation trading likely to continue to dominate…

We noted above the many traditional FX drivers that are unlikely to come into play in the fourth quarter and possibly not until the middle of next year, namely interest rates and solid growth expectations. In their absence, we think the inter-market correlations are likely to continue to dominate short-term trading. With US rates most likely to remain low, the USD should continue as a funding currency and this will maintain the inverse relationship between the dollar and risk assets overall. In FX, we see the strongest correlations between stock markets and the euro, Swiss franc and sterling. Aussie, Canada, and Kiwi are most closely linked to a combination of stocks and commodities. For the JPY, US Treasury yields are the most important driver.

Waning stimulus, soaring deficits and rising unemployment…

Many countries will see the impact of fiscal stimulus begin to wane in the coming months. Cash for clunkers in the US has ended, the UK version may could an extension until January 2010, but the UK’s VAT reduction will be reversed on January 1 2010. Germany’s fiscal incentives may last a little longer but the benefit of France’s fiscal incentives is already coming to a halt. Rising budget deficits means that for many countries the emphasis of 2010 will be on government spending cuts. The US and UK could this year see their budget deficits rise to the region of 13% of GDP. To put this in perspective, the budgetary criteria of the Maastricht Treaty (relevant for countries joining EMU) specified a budget deficit of no bigger that 3% of GDP as an acceptable benchmark. Coincident with the reduction in fiscal spending will be continued increases in unemployment, albeit at a slower pace in the months ahead. US unemployment has already reached 9.7%, in the UK the rate of joblessness stands at 7.9%. In Spain, unemployment has risen to 17.9%; equivalent to almost 1 in 5 of adults participating in the labor market.

Inflation not on the radar screen; central banks likely on hold…

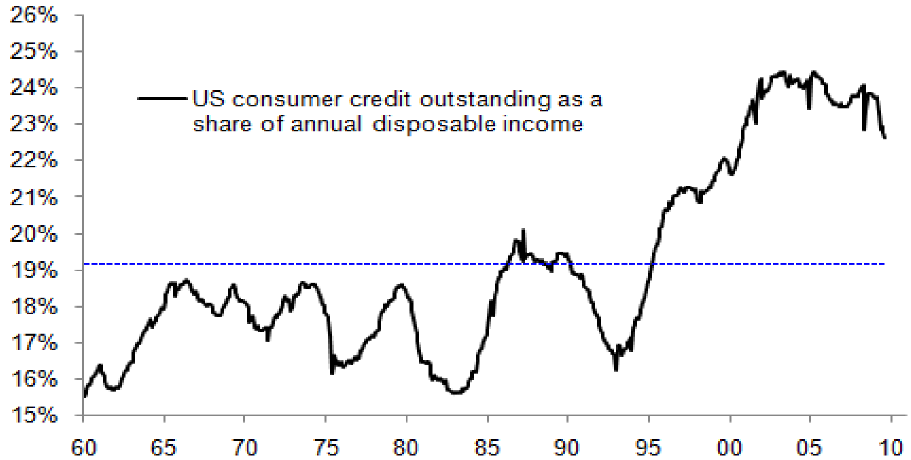
On the inflation front, high levels of unemployment are coincident with high levels of excess capacity. The same story is told by the relatively low levels of the Baltic Dry Index, and the high levels of oil inventories relative to the seasonal average. The Bloomberg survey points to US CPI at just -0.5% y/y at year end. Eurozone CPI is already at a deflationary -0.2% m/m and German CPI is at -0.4% y/y in Sep. The UK is the potential outlier with CPI presently at a higher 1.6% y/y and forecast to rise to 2.0% y/y potential by year-end. This could imply that perhaps the BoE could hike rates ahead of the Fed or perhaps more aggressively once it starts to raise rates. This outlook, however, has few implications sterling during Q4. We continue to expect a weak pound during Q4 and potentially into Q1.After that there is scope for a sterling recovery if the threat of forthcoming rate hikes is accompanied by a recovery in growth and spending cuts. As the impact of fiscal stimulus tapers off the risk of a 'w' shaped recession may become real. This situation would prompt safe haven flows and thus benefit the USD. The rhetoric of most G-10 central banks continues to recognize that the recovery could be a bumpy road. It is possible that the Fed and the ECB could be on hold until Q3 2010.

The clear outlier is Australia, which raised rates this week. Australia avoided technical recession in part due to its proximity to China and its huge wealth of natural resources. Australia has also seen steep improvements in its housing and labor markets. These factors are underpinning the AUD as it the relative health of its banking system. Norway could also hike rates before the end of the year. Its economy is hugely insulated by its oil fund and even at the peak of this downturn unemployment rise to just 3%. Canada is another contender for an early rate hike.

Risk rally is overdone and ripe for a correction…

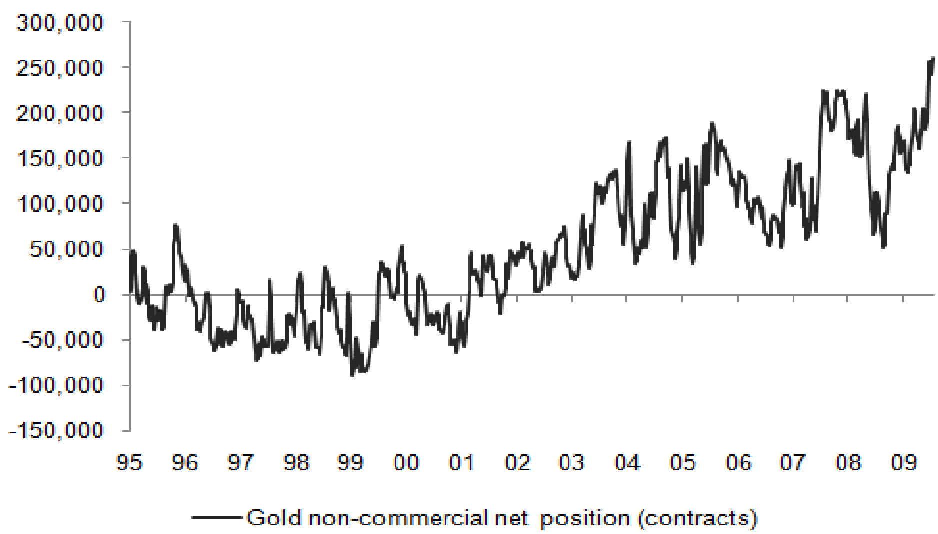
The current rally in risk is overdone in our view as stock market valuations are stretched, providing little incentive for the long-term investor to come into the market. The US equity market is currently trading at a price-to-earnings (P/E) ratio around 20 and this is well above the 17.5 historical average. In the past, when an investor bought stocks trading above average P/E, the average annual real return over the ensuing decade was a measly 0.5%. On the flip side, investors who bought the market when the P/E was below average yielded an average real 10-year return of 4.1% per annum.

The US consumer holds the key in terms of the earnings outlook and by our calculations we still need to see a credit contraction of nearly $500 billion. This is roughly 5% of annual consumer spending and suggests that, should the consumer decide to de-lever in a significant way, corporate earnings will suffer. Our view of a stock market correction is one of the major underpinnings for our USD rebound outlook. Given the negative correlation between the USD index and stocks all year (at about -95%) a major correction in equities would see a commensurately massive rally in the buck.



Headwinds for the commodity rally…

Oil: Our outlook for the commodity space is likewise cautious. We expect oil to pullback on both supply/demand fundamentals and seasonal trends while the long gold trade looks more and more crowded every week. Buttressing the constructive supply outlook for oil are the more than 200 discoveries thus far this year and the fact that Russian oil production rose to 10 million barrels per day for the first time ever in September. The seasonal pattern observed since 1990 shows a considerable decline in oil prices in 4Q and we are expecting a retracement back towards the $55/bbl area by year-end.



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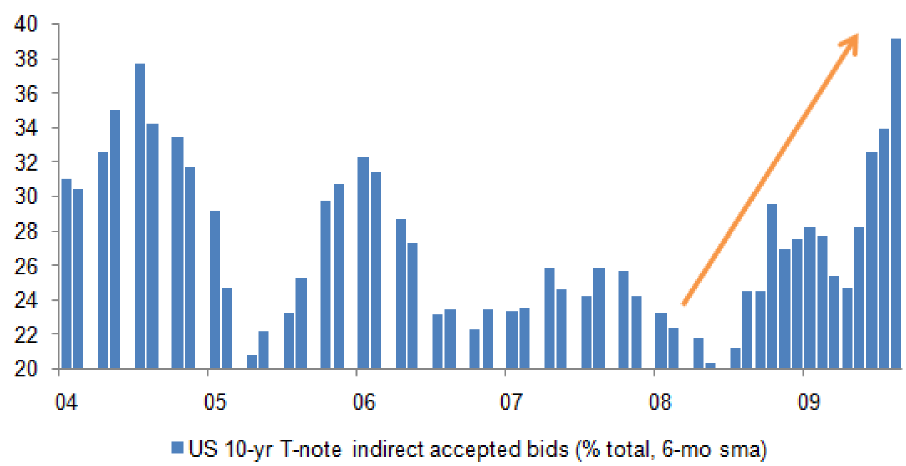
Gold: The gold picture is a little less clear. Fundamentally, gold has decoupled with inflation and its use as an "inflation hedge" is questionable in the near-term. If we look at 10-year US Treasury breakevens (so the nominal yield minus the inflation protected rate) the market is pricing below 2% inflation as far as the eye can see. The long position in gold also looks extremely crowded, reaching a record of 260K contracts (futures and options) in the second week of October. The last time we had such a skewed position on, gold collapsed more than -25% over the following three months. The seasonal pattern here is a major risk. The trend over the last two decades suggests a short-term correction to around $950/940 early in 4Q but then a rally into the end of the year towards the $1150 area. Given our bearish view with regards to risky assets, however, we would expect any correction lower in the precious metal to be sustained for a bit longer this time.

Negligible risk of a US funding crisis…

The probability of a disorderly USD collapse is extremely low given strong demand for US paper and the fact that this is unlikely to slow in the short-term. Demand for US Treasuries remains robust and nowhere has this been clearer than in the 10-year maturity. We track the six-auction average of the percentage of indirect take (proxy for foreign central banks) and the trend is decidedly higher – currently well above 40%. Should Treasury auctions start to falter, we believe China will be compelled to support them. The country currently holds a massive $800 billion Treasury portfolio and it is in their interest to not allow a poor auction to drive yields higher – as this would significantly impact their portfolio value. Unwinding this massive bond position is out of the question in the short-term as well, given that the flight from Treasuries we would likely see across the board would make any net benefit from immediate diversification negligible.



Additional stimulus a fiscal risk…

More government spending remains a risk to the US fiscal position. While the health care bill making the rounds on Capitol Hill is deemed to be "revenue neutral", experts agree that this is highly unlikely – putting the price tag anywhere between $1 and $2 trillion dollars. Frankly, we can't remember the last time the government came within budget on anything. Moreover, the government looks willing and able to help the economy along at all costs and we would not be surprised to see programs similar to “cash for clunkers” in other areas of the economy along with an extension of the first-time homebuyer tax credit emerge in the near future. Should the US government embark on yet another spending spree, the risk of a USD funding crisis would grow and this would elicit considerable downside pressure on the buck. We view this as more of a 2010 story at this point though.

4Q Trading Strategies…

- **Sell EUR/USD 1.4700/1.4900 or if below 1.4450; stop 1.5300; target 1.3800**
- **Sell GBP/USD 1.6300/1.6500 or if below 1.5770; stop 1.6700; target 1.5200**
- **Buy USD/JPY 87.50/89.50 or if above 91.50; stop 85.00; target 98.00**
- **Sell XAU/USD (gold) 1050/1075 or if below 980.00; stop 1100; target 870/900**
- **Sell BCO/USD (Brent) 68/72 or if below 63.50; stop 74.50; target 55.00**